No. 14775

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ELMER J. THOMPSON, HELEN H. THOMPSON,
Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPELLANTS' OPENING BRIEF.

NATHAN J. NEILSON,
412 West Sixth Street,
Los Angeles 14, California,
Attorney for Appellants.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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Jurisdiction and Venue.

Appellants ELMER J. THOMPSON and HELEN H. THOMPSON, husband and wife, are residents of the County of Los Angeles, State of California, and have resided there continuously since prior to 1945. This controversy involves appellants' Federal Income Taxes for the year 1949. The appellants filed their Federal Income Tax Returns for the year 1949 in the Office of the Collector of Internal Revenue for the 6th Collection District of California, at Los Angeles, California. [Rec. pp. 1 and 7.]

Jurisdiction in this Court to review the decision of the Tax Court of the United States, entered January 10, 1955, finding a deficiency in the amount of $150.00, for each appellant, in individual income taxes for the calendar year 1949, is founded on Sections 7482 and 7483 of the Internal Revenue Code of 1954 (formerly Secs. 1141 and 1142 of the 1939 Internal Revenue Code).

Statement of the Case.

This controversy relates to the proper determination of appellants' Federal Income Taxes for the calendar year 1949. Respondent determined an Income Tax deficiency of $150.00 for each appellant, for the calendar year 1949 by disallowing a claimed bad debt loss arising out of a transaction entered into in 1945 and 1946 with one JACK MILLER.

The Tax Court of the United States, by its said decision sustained respondent in his determination.

The facts in this case, upon which appellants rely in support of their appeal are briefly as follows:

1. On or about the 10th day of July, 1945, the taxpayer, Elmer J. Thompson, and Jack Miller executed a document entitled "Articles of Co-Partnership." This document provided for a limited partnership between the two parties for the purpose of engaging in the mining business in the State of Arizona, with the principal office and place of business in the County of Los Angeles, State of California; the name of the firm was to be "Miller Mining Co."; Jack Miller was to be the general partner and was to be entitled to seven-eights (7/8) of all of the profits of the partnership; the taxpayer, E. J. Thompson, was to be the limited partner and was to receive a one-eighth (1/8) interest in and to all of the profits of the partnership; Elmer J. Thompson was to contribute the sum of six thousand five hundred dollars ($6,500.00) for the said one-eighth (1/8) interest. The document was apparently pre-typed with blank spaces being provided for filling in the date, the name of the limited partner, and the amount of the limited partner's contribution, these items

being written in in ink upon the executed document. [R. pp. 11-15, 34 and 46.]

2. On or about the 12th day of December, 1945, the taxpayer, E. J. Thompson, and Jack Miller executed a second document entitled "Articles of Co-Partnership." This was substantially identical in its provisions with the aforesaid document executed on July 10, 1945, except that the contribution of E. J. Thompson was to be six thousand dollars ($6,000.00) for a one-eighth (1/8) interest. The limited partner's name and the amount of the contribution were typed in in this document. On the last page of the document following the signatures was this statement: "This is to acknowledge the sale of additional (1/8) interest in and to all of the profit of said partnership." The signature of Jack Miller was subscribed thereunder. [R. pp. 16-20, 34 and 46.]

3. The taxpayers advanced to the said Jack Miller, in reliance upon and in accordance with the provisions of the aforesaid purported limited partnership agreements, the total sum of fourteen thousand seven hundred dollars ($14,700.00) on the dates and in the amounts set forth below:

Date of Check	Type of Check	Amount of Check
February 6, 1945,	Taxpayer's Personal	$ 1,500.00
August 6, 1945,	Taxpayer's Personal	1,000.00
August 13, 1945,	Taxpayer's Personal	1,500.00
October 29, 1945,	Taxpayer's Personal	2,500.00
December 14, 1945,	Bank Cashier's Check	6,000.00
March 7, 1946,	Bank Cashier's Check	1,500.00
April 6, 1946,	Bank Cashier's Check	700.00
		$14,700.00

[Stipulation, p. 2; R. pp. 34-35 and 47.]

4. No Certificate of Limited Partnership for the purported limited partnership was ever executed, sworn to or acknowledged by the taxpayer. [R. p. 35.]

5. No Certificate of Limited Partnership was ever filed with the Clerk of Los Angeles County. [Pet. Ex. 4—Los Angeles County Clerk Certificate; R. pp. 35, 54.]

6. No permit authorizing the sale and issuance of securities was ever issued by the Department of Investment, Division of Corporations, State of California, to Jack Miller and/or Miller Mining Co., to and including May 21, 1954. [Pet. Ex. 6—Certificate of Commissioner of Corporations; R. pp. 36, 58.]

7. No financial statement or copies of partnership tax returns pertaining to the alleged partnership were ever received by the taxpayers. [R. pp. 35-36.]

8. No part of the aforesaid sums advanced by the taxpayers to Jack Miller in connection with the purported limited partnership was ever recovered by or returned to the taxpayers. [R. p. 35.]

9. The taxpayers were furnished information in the year 1947 by the said Jack Miller with respect to three allegedly then existing mines. [R. p. 35.]

10. The taxpayers' last contact with the said Jack Miller was sometime near the middle of the year 1947. [R. p. 36.]

11. The taxpayers believed, in the year 1947, on the basis of information received from Jack Miller, that they would get their money back.

12. The taxpayers believed, in the year 1948, that there was still a posisbility of locating the said Jack Miller.

13. On the 12th day of July, 1945, a Certificate Under Uniform Partnership Act of Miller Mining Co. was filed with the County Clerk of the County of Los Angeles, the said Certificate showing Jack Miller to be the general partner and R. R. Crabtree to be the limited partner. [Pet. Ex. 4—Los Angeles County Clerk Certificate; R. pp. 54-57.]

14. Taxpayers offered in evidence a certified copy of the aforesaid Certificate Under Uniform Partnership Act, certified to by the Los Angeles County Clerk, but the Court sustained the respondent's objection to its admission.

15. Mr. Dan Jones, 3968 Wilshire Boulevard, Los Angeles, California, invested fourteen thousand dollars ($14,000.00) with the said Jack Miller, in 1946, in a limited partnership known as the "Miller Mining Co.", for which and in which he was to receive a twenty-five per cent (25%) interest.

16. The taxpayers' United States Individual Income Tax Returns as filed for the years 1947 and 1948, in the office of the Collector of Internal Revenue, Los Angeles, California, disclose no capital gains. [Stipulation, p. 2; R. pp. 35, 47.]

Questions Involved.

There are only two simple basic questions involved in this controversy:

1. Did appellants suffer a "bad debt" loss as a result of their transaction with the said Jack Miller?

2. If they suffered a "bad debt" loss, in what year did the loss occur?

Specification of Errors.

The appellants hereby set forth the following assignments of error on the part of the Tax Court of the United States, on which they intend to rely:

(1) The failure to make separate determination as to:
   (a) The question of the validity of the bad debt deduction claimed; and
   (b) The year of loss.

Appellants have on file with the Internal Revenue Service a Claim for Refud, timely filed, claiming the said bad debt loss also in each of the years 1947 and 1948. If the loss is held to have occurred in either of said years the appellants would nevertheless be entitled to the deduction claimed in 1949 under the provisions of the Internal Revenue Code pertaining to "capital loss carryovers."

(2) The failure to hold that California State law applies to the question of the determination of whether a debtor-creditor relationship resulted from the subject transaction.

(3) The failure to hold that a debtor-creditor relationship resulted, under both State and Federal law, as a result of each of the following events:
   (a) Failure to execute and file Certificate of Limited Partnership.
   (b) Failure to obtain Permit from Division of Corporations to sell and issue interests in a limited partnership where no Certificate of Limited Partnership was filed.

(c) Failure to obtain Permit from Division of Corporations to Sell and Issue interests in a mining venture.

(d) Fraud on the part of Jack Miller in failing to disclose that there were other partners and in failing to obtain permit to sell interests.

(4) The sustaining of objection to admission into evidence of the filing of a Certificate under Uniform Limited Partnership Act of Miller Mining Co., in the office of Los Angeles County Clerk, by Jack Miller, on July 12, 1945.

(5) The failure to find with respect to the sale of an interest in the limited partnership, Miller Mining Co., by Jack Miller to Don Jones for fourteen thousand dollars ($14,000.00) about January, 1946.

(6) The failure to determine that petitioner sustained a bad debt loss; and that the loss was deductible in the year 1949.

(7) The determination of a deficiency for the year 1949 in lieu of a determination that there was no income tax due from appellant for the year 1949.

ARGUMENT.

1. Local Law or Federal Statute?

Primarily, the issue to be decided in this matter is whether the relationship of the taxpayers to Jack Miller was a debtor-creditor relationship. For that purpose, local law will govern, the question being one of property rights primarily and of income tax law only secondarily, there being no clear-cut federal rule or provision as to the determination of such a relationship. *Mertens Law of Federal Income Taxation* contains two sections relating to this subject as follows:

> *Section 61.09.*
>
> 61.09—Supreme Court's Rule of Distinction. While the federal courts have generally sought to respect the decisions of the state courts regarding rules of property in the interpretation of the income tax law, this has not been possible in every instance and a conflict has frequently resulted. The Supreme Court has attempted to resolve the conflict by establishing two rules, as follows:
>
> (1) Where the question is the meaning of a federal statute, such as the revenue act, the will of Congress controls, and the federal statute is to be interpreted so as to give a "uniform application to a nationwide scheme of taxation," so that taxation may not be escaped through local decisions.
>
> (2) Where the will of Congress depends upon a fact which can be interpreted only according to a state rule of property, as upon the question whether title has passed under state law, the state rule will govern.

Section 61.13—Validity, Effect and Nature of Transactions. Local Restrictions and Prohibitions.

Validity and effectiveness of transactions for federal tax purposes often turn upon local law. Here again the local law, or some local adjudication, cannot control if there is a clear-cut federal rule or provision as to how the transaction shall be treated.

Thus state law is not necessarily controlling as to what constitutes a "sale" as distinguished from a lease or exchange, the validity or effectiveness of a gift or, what constitutes "payment" of interest. On the other hand, local law may be considered in determining the quantum of evidence required to establish a gift between parent and child, whether there was such consideration for a transfer as to take it out of the gift category, existence of liability upon obligations entered into (to detemine deductibility of claimed losses or uncollectibility).

In the case of *William Park,* 38 B. T. A. 1118, aff'd 113 F. 2d 352 (C. C. A. 3d, 1940), it was held that Pennsylvania law was controlling in upholding a note under seal, despite fact that the giving of consideration was not clearly shown.

In the *Sterling Morton* case, 38 B. T. A. 1270, aff'd 112 F. 2d 320 (C. C. A. 7th, 1940), it was held that Illinois law was controlling to determine whether there is an enforceable obligation in the case of interest due on a note executed on behalf of a syndicate by the syndicate manager pursuant to the authority granted him by the syndicate agreement.

In *Humphrey v. Comm.,* 91 F. 2d 155 (C. C. A. 9th, 1937), it was held that local law governs with respect to liability under a guaranty agreement, in determining whether payment of the same is a deductible loss.

In the *E. A. Roberts* case, 36 B. T. A. 549, it was held that local law governs in the determination of the liability of an endorser of a note for the purpose of establishing a bad debt.

2. Interest in Mining Lease—a "Security."

The interest in the limited partnership which Jack Miller attempted to sell to the taxpayers was a "security," on the basis and authority of code sections and cases immediately following, because it was "a certificate of interest in a mining title or lease." The business to be engaged in, according to the agreements executed, was the mining business in the State of Arizona, Section 25008 of the Corporations Code defines a security as:

Corporations Code, Section 25008. Security.

"Security" includes all of the following:

(a) Any stock, including treasury stock; any certificate of interest or participation; any certificate of interest in a profit-sharing agreement; any certificate of interest in an oil, gas, or mining title or lease; any transferable share, investment contract, or beneficial interest in title to property, profits, or earnings.

(b) * * *.

In *People v. Marr* (1941), 46 Cal. App. 2d 39, 115 P. 2d 214 (Dist. Ct. Ap.—4th Dist.), it was held that Corporate Securities Act, Section 2(a)(7) included certificates of interest other than those specifically mentioned, namely, certificates of interest in a profit-sharing agreement, and those in an oil, gas or mining title or lease. The statute includes as a security a certificate of interest or participation in a corporation or association.

In *People v. Dutton* (1941), 41 Cal. App. 2d 866, 107 P. 2d 937, defendant sold interests in the profits of a Shasta County mining venture through use of limited partnership agreements.

Trial court instructed jury that the instruments in question were securities under the law and a permit for their sale was required.

Appellate Court held that question of whether instruments were securities or not was one of law and not one of fact for jury to determine.

Other cases interpreting Corporations Code, Section 25008 are:

Agnew v. Daugherty (1922), 189 Cal. 446, 209 Pac. 34;

Barnhill v. Young (1931), 46 F. 2d 804;

People v. Jackson (1937), 24 Cal. App. 2d 182, 74 P. 2d 1085;

Moore v. Stella (1942), 52 Cal. App. 2d 766, 127 P. 2d 300, 51 A. C. A. 42, 124 P. 2d 167;

People v. Sidwell (1945), 27 Cal. 2d 121, 162 P. 2d 913, 65 A. C. A. 878, 151 P. 2d 145.

3. Limited Partnership Interest—a "Security."

The interest in the limited partnership which Jack Miller attempted to sell to the taxpayers was a "security" because it was an interest in a limited partnership and was not exempt as such because no certificate was ever executed, recorded or filed.

Section 25100 of the *Corporations Code of the State of California* relating to securities which are exempt under the Act provides:

"Except as otherwise expressly provided in this division, the Corporate Securities law does not apply to any of the following classes of securities:

(a) * * *

(1) Any partnership interest in a general partnership, or in a limited partnership where certificates are executed, filed, and recorded as provided by Sections 15502 and 15525 of the Corporations Code of the State of California, except partnership interests when offered to the public."

In *People v. Woodson* (1947), 78 Cal. App. 2d 132, 177 P. 2d 586, defendant sold interests to four or five people, in an alleged cattle ranch, through use and by means of limited partnership agreements, each party to share in the profits.

It was held that the issuance of partnership securities and limited partnership agreements without a permit are prohibited by Corporate Securities Act.

Certificates of limited partnership and certificates of interest in a profit-sharing agreement whereby the limited partner or a person holding an interest in a lease or agreement is to receive a percentage of the profits to be realized from the common venture, are "securities" within the meaning of the Corporate Securities Act.

In *People v. Hosher* (1949), 92 Cal. App. 2d 250, 200 P. 2d 882 (Dist. Ct. Ap., 2d D. Cal.), the defendant, by means of limited partnership agreement, sold interests in assets and profits of some seven juice bars. The court held that evidence that the promoter as a general partner sold interests in seven limited partnerships and as an individual sold certificates of interest in business of which he was sole proprietor, without having first ob-

tained permits to do so, sustained conviction of violating Corporate Securities Act.

Another case interpreting this code section is *People v. Simonsen* (1923), 64 Cal. App. 97, 220 Pac. 442.

4. Partnership Interest Sold to Public—a "Security."

The interest in the limited partnership which Jack Miller attempted to sell to the taxpayers was a "security" because it was a partnership interest sold to the public and was not exempt under the aforesaid Corporations Code, Section 25100.

The evidence in this case shows that interests in the limited partnership, Miller Mining Co., were sold to R. R. Crabtree, Dan Jones, and the taxpayers all at different times and places. There was no showing that there was ever a meeting of these parties or any discussions or conferences leading to a joint agreement to form a limited partnership.

No definition of the term "public offering" appears in either of the California statutes or the California Corporation Commissioner's published rules and the California courts have had little to say on the subject. Two California cases are worthy of note:

Mary Pickford Co. v. Bayly Bros., Inc., 12 Cal. 2d 501, 514 (1939), established that where persons are solicited at random, a public sale occurs even if the group solicited is small.

Black v. Solano Co., 114 Cal. App. 170, 177-178 (1931), stands for the proposition that the character of the offering is the controlling factor; there may be a public offering even though the ultimate sale includes only a few persons and could be considered a private transaction.

5. Sale of Security—Void if No Permit.

The sale of the purported partnership interest, which was a "security" for the reasons above set forth, was void because Jack Miller had never obtained a permit for the sale of the same from the Division of Corporations of the State of California.

Section 26100 of the Corporations Code of the State of California covering issuance or sale of securities without permit or in non-conformity with permit provides:

> "Every security of its own issue sold or issued by any company without a permit of the Commissioner then in effect authorizing the issuance or sale of the security is void. Every security of its own issue sold or issued by a company with the authorization of the commissioner but which has been sold or issued in non-conformity with any provision in the permit authorizing the issuance or sale of the security is void."

In *Randall v. Beber* (1951), 107 Cal. App. 2d 692, 237 P. 2d 994, it was held that a legislative intent to void a sale of corporate securities in non-conformity with the provisions of this act is inferable from the imposition of statutory penalties therefor.

In *Black v. Solano Co.* (1931), 114 Cal. App. 170, 299 Pac. 843, it was held that a sale without a permit of percentage of oil and gas to be produced was void even though the sale was private.

Other cases holding securities sold without a permit to be void are:

First National Bank v. Thompson (1931), 212 Cal. 388, 298 Pac. 808;

El Clare Oil & Gas Co. v. Daugherty (1930), 11 Cal. App. 2d 274, 53 P. 2d 1028, 55 P. 2d 488.

6. If Security Sale Void Seller Becomes Debtor of Buyer.

The law is well established that when a security, requiring a permit for its sale, has been sold without a permit having been issued, or in violation of the terms of a permit, the seller become indebted to the purchaser and the purchaser may recover the amount paid. For statement of the general rule, 87 A. L. R. 107, (b), *Recovery by Purchaser,* provides:

> "The penalties of the Blue Sky Law are visited on the seller and not on the buyer, the statute being for the benefit and protection of the buyer, and if the buyer is not *in pari delicto* with the seller (and he is generally not so regarded), the general rule is that he may, within a reasonable time, recover his money, or property exchanged for stock, by tendering back the stock received by him."

In *Garner v. Hogsett* (1948), 84 Cal. App. 2d 657, 191 P. 2d 497, it was held the amount paid for a security issued in violation of law may be recovered in an action for money had and received, without pleading a violation of the act.

In *Woods v. Deck* (1940), 112 F. 2d 739, it was held that certificates of interest in an oil venture, sold without a permit of the commissioner are void and purchasers thereof may recover the money paid in an action for money had and received or by an action for fraudulent misrepresentation as to the validity of the certificates or in an action for breach of implied warranty of validity.

In *Becker v. Stineman* (1931), 115 Cal. App. 740, 2 P. 2d 444, it was held that the stock issued in exchange for property was void. There was a failure of consideration entitling the person making the exchange to recover the property or its value.

In *Building Finance Ass'n Inc.* (1928), 26 F. 2d 123, (Dist. Ct., So. Dist. Calif.), it was held that claims against corporations of persons illegally purchasing stock must be considered in determining whether corporation was solvent within meaning of Bankruptcy Act.

Claims against corporation or shareholders who purchase stock with property instead of cash, in violation of permit given under Corporate Securities Act, must be considered as claims against corporation for money had and received in determining whether corporation was insolvent—notwithstanding the general rule that courts will not afforded relief to parties *in pari delicto* * * *.

Question was whether claims of stockholders were to be considered as liabilities of the corporation.

Other cases on recovery where securities sold without a permit are:

Stallman v. Schwartz (1946), 76 Cal. App. 2d 406, 173 P. 2d 388;

Pollak v. Staunton (1930), 210 Cal. 656, 293 Pac. 26;

O'Connell v. Union Drilling & Petroleum Co. (1932), 121 Cal. App. 302, 8 P. 2d 867;

Barrett v. Gore (1928), 88 Cal. App. 372, 263 Pac. 564.

7. No Certificate—No Limited Partnership.

The proposed limited partnership never came into being for another separate and distinct reason—there was no compliance with the California statute governing formation of limited partnerships. *Section 15502 of the Corporations Code of the State of California* dealing with the formation of limited partnerships provides:

"(1) Two or more persons desiring to form a limited partnership shall

"(a) Sign and swear to certificates in duplicate, which shall state * * *

"(b) File one of said certificates in the clerk's office and file the other for record in the office of the recorder of the county in which the principal place of business of the partnership is situated, and if the partnership has places of business situated in different counties, a copy of the certificate, certified by the recorder in whose office it is recorded, must be filed in the clerk's office and recorded in like manner in the office of the recorder in each such county.

"(2) A limited partnership is formed if there has been substantial compliance in good faith with the requirements of paragraph (1)."

In order to have a limited partnership there must have been strict compliance with the Code. In this case, the parties failed to execute a certificate at all and there was, accordingly, no filing and no recording.

In *Churchill v. Peters, et al.* (Dist. Ct. App., 4th Dist.) (March, 1943), 57 Cal. App. 2d 521, 134 P. 2d 841, defendant had plaintiff sign document called "Original Articles to Certificate of Limited Partnership of the E. A. Peters Oil Company." Certificate was not filed as required by Section 2478 of the Civil Code. Certificate was not sworn to. The court stated: * * * no such limited partnership was "created or organized" under Section 2478 of the Civil Code, and that no general partnership, association or joint adventure was thus organized or created, but an involuntary trust resulted from the transaction."

The Court also held: Where defendant not only sold certificates or interest in a purported limited partnership

and oil and gas lease without complying with Corporate Securities Act, but also obtained money for certificates by means of false representations, an "involuntary trust" was created in favor of the investors paramount to any alleged interest of defendant in lease or profits therefrom. (Civ. Code, Sec. 2224.)

In *People v. Hosher* (1949), 92 Cal. App. 2d 250, 206 P. 2d 882, it was held the issuance of a certificate of a limited partnership in a manner not authorized by former Civil Code, Sections 2478, 2501, was an act denounced by former Corporate Securities Act, Section 2a(7).

8. General Partnership Does Not Result From Failure of Limited Partnership.

When an attempt to organize a limited partnership fails and the proposed limited partnership does not come into existence, it does not follow that a general partnership results.

Section 15511 of the Corporations Code of the State of California dealing with persons erroneously believing themselves limited partners, provides:

> "A person who has contributed to the capital of a business conducted by a person or a partnership erroneously believing that he has become a limited partner in a limited partnership, is not, by reason of his exercise of the rights of a limited partner, a general partner with the person or in the partnership carrying on the business or bound by the obligations of such person or partnership; provided, that on ascertaining the mistake he promptly renounces his interests in the profits of the business, or other compensation by way of income."

The Section in American Law Reports, 18 A. L. R. 2d 1360, dealing with this subject provides:

> "Section 11 of the Uniform Limited Partnership Act applies so as to relieve all persons who erroneously believed that they became limited partners, either in a partnership organized under the old statutes, or in one organized under the Uinform Act."

In *Rathke v. Griffith* (Wash., 1950), 218 P. 2d 757, it was held in part: Hence, one who joined a partnership as a limited co-partner is not liable as a general partner for partnership debts, even though, because of defects in the organization of the partnership, and, in particular, the failure to publish the certificate of partnership, he would have been so liable under the statutes in force at the time the partnership was organized, and even though the partnership never became a limited partnership under the Uniform Limited Partnership Act, which provides that a limited partnership formed prior to its adoption, unless it becomes a partnership under the Act, should continue to be governed by the provisions of the former statutes.

9. Involuntary Trust—Fraud.

A debtor-creditor relationship arose between the taxpayers and Jack Miller on the ground of fraud.

Section 2224 of the Civil Code of the State of California, dealing with involuntary trusts resulting from fraud, mistake, etc., provides:

> "One who gains a thing by fraud, accident, undue influence the violation of a trust, or other wrongful act, is, unless he has some other and better right thereto, an involuntary trustee of the thing gained, for the benefit of the person who would otherwise have had it."

The selling of securities itself, without a permit when a permit is required, may be sufficient fraud for recovery under the Civil Code Section.

In *Taormina v. Antelope Mining Corp.* (1952), 110 Cal. App. 2d 314, 242 P. 2d 665, it was held a seller of a security impliedly represents that a permit necessary for its valid sale has been secured, and such representation, if false, constitutes actionable fraud.

10. "Debt" Defined.

The debtor-creditor relationship which resulted from the acts of the taxpayers and Jack Miller under the statutes and cases as set forth above, meets the requirements of a debt for federal income tax purposes.

In *Henry v. Burnet, Comm. of Int. Rev.* (1931), 8 B. T. A. 1089, Dec. 3000 aff'd (C. A. of D. C.), 48 F. 2d 459, it was held a debt may be defined as that which is due from one person to another, whether money, goods, or services; that which one person is bound to pay to another, or to perform for his benefit. It also has been defined to mean "every claim and demand upon which a judgment for a sum of money or directing payment of money, could be recovered in an action."

Wherefore, the appellants respectfully pray that this Court may determine and sustain their appeal.

NATHAN J. NEILSON,

Attorney for Appellants.